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UNITED STATES DISTRICT COURT

CENTRAL DISTRICT OF CALIFORNIA

WESTERN DIVISION

NATIONAL CREDIT UNION ADMINISTRATION BOARD AS CONSERVATOR FOR WESTERN CORPORATE FEDERAL CREDIT UNION, Plaintiff, vs. ROBERT A. SIRAVO, et al., Defendants.	No. CV 10-01597 GW (MANx) **REPLY IN SUPPORT OF DIRECTOR DEFENDANTS' MOTION TO DISMISS PLAINTIFF'S FIRST AMENDED COMPLAINT** Honorable George H. Wu Courtroom 10 312 North Spring Street Date: December 20, 2010 Time: 8:30 a.m. Courtroom: Los Angeles, 10

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I. SUMMARY OF ARGUMENT.

If the Business Judgment Rule means anything, it means that before a plaintiff can seek billions of dollars of damages from unpaid volunteer directors unsullied by any conflicts of interest or ulterior motives, the plaintiff must make cogent factual allegations strongly suggesting that the directors blinded themselves to reality, acted in bad faith or lacked any rational business purpose. The NCUA's First Amended Complaint, Doc. 84 ("FAC") does not do that here, and nothing in the NCUA's opposition to the directors' motion to dismiss, Doc. 102 ("Opposition" or "Opp.") demonstrates otherwise.

First Claim (ordinary negligence): The Opposition misconceives the Business Judgment Rule as applied in California – applying the wrong statute, misreading Supreme Court precedent and dismissing in a footnote the most important aspect of the Rule. Building on this foundation of legal error, the Opposition then seizes on WesCorp's non-profit status, utterly ignoring the fact that whether or not WesCorp turned a profit, it was in the business of investing its members' money, and making business judgments between risk and reward – exactly the activity that the Business Judgment Rule is meant to protect.

Much of the Opposition is devoted to the argument that the FAC's allegations, while focusing on content not process, and while utterly devoid of specifics, ought to receive the benefit of the doubt and glide past a motion to dismiss and into discovery – never mind that the NCUA has had all WesCorp's records for the last 18 months and every opportunity to develop a cogent fact-based claim, if it could. This plea is exactly backwards. If the Business Judgment Rule means anything, it means that weak, conclusory hindsight-based disagreements with an investment strategy ought not survive a motion to dismiss merely because the damages claimed are very large. Indeed, as courts have observed, this is exactly when the Rule should be applied with especial care. And, contrary to what the Opposition suggests, courts do apply the Rule to weed

out weak claims at the pleadings stage – a fact not obscured by the Opposition's attempts to distinguish on irrelevant grounds cases illustrating exactly this point.

On the few occasions when the Opposition focuses not on the content of Defendants' decisions, but instead on the process by which they gathered information for use in decision-making, the Opposition again misses the main point. The law is clear that conclusory allegations on process are not enough – because in hindsight one could always have done something more, or something different. Instead a plaintiff must plead facts showing that "red flags" existed at the time, and further investigation would have uncovered material facts that would have led to a different decision. The Opposition simply ignores this because the FAC does not allege this.

Second Claim (gross negligence): The Opposition argues that it can state such a claim, despite clear Supreme Court and Ninth Circuit precedent to the contrary – precedent showing that there is no such federal claim in a state such as California, where state law permits claims for negligence. The Opposition then argues that the same conclusory allegations it offers to establish negligence also establish gross negligence, even though the FAC candidly admits that Defendants acted with much more than the "some care" sufficient to rebut a claim of gross negligence.

Statute of limitations: Here too the Opposition makes fundamental legal errors, failing to follow binding Ninth Circuit authority in favor of a baseless argument that if accepted (as no circuit has) would permit the NCUA to resuscitate claims dating from the middle of the last century. The NCUA knows full well that it lacks the statutory basis to revive expired claims – indeed, lacks even the FDIC's limited power to do so (which in any event would not avail it here). And if that were not enough, the Opposition completely ignores the fact that the FAC does not specifically allege even one wrongful act within any conceivable limitations period.

II. ARGUMENT.

A. The FAC's First Claim must be dismissed.

1. The Business Judgment Rule applies to WesCorp's directors.

The NCUA's argument begins by asserting that California Corporations Code section 7231 marks the outer boundaries of the Business Judgment Rule applicable to WesCorp and is narrower than the Business Judgment Rule applicable to for-profit corporations. Opp. at 8:20-9:22 & 8 n.4, 12:4-13:9. All parts of this argument are wrong.

First, neither Corporations Code section 7231 nor Corporations Code section 309 define the outer bounds of the Business Judgment Rule; both merely codify one part of the common-law Business Judgment Rule (section 7231 for mutual benefit corporations, and section 309 for general corporations), leaving the rest of the Rule to the common law. In California, the Business Judgment Rule "has two components – one which immunizes directors from personal liability if they act in accordance with its requirements, and another which insulates from court intervention those management decisions which are made by directors in good faith in what the directors believe is the organization's best interest. *Only the first component is embodied in Corporations Code section 309*." *Lee v. Interinsurance Exchange*, 50 Cal. App. 4th 694, 714, 57 Cal. Rptr. 2d 798, 810 (1996) (emphasis added) (citation omitted); *see also Berg & Berg Enters., LLC v. Boyle*, 178 Cal. App. 4th 1020, 1045, 100 Cal. Rptr. 3d 875, 897 (2009). The uncodified part of the Rule is a judicial policy of deference to the business judgment of corporate directors and officers in the exercise of their broad discretion in making corporate decisions. Based on this common law policy, "[i]nterference with the discretion of directors is not warranted in doubtful cases." *Lee,* 50 Cal. App. 4th at 715 (citation omitted). No matter which statutory section applies to WesCorp, Defendants' business decisions are protected by the policy of judicial deference embodied in the common law

aspects of California's Business Judgment Rule. The NCUA recognizes the common-law component of California's Business Judgment Rule, but claims without discussion or citation that it is "not at issue in this motion." Opp. at 8 n.3. That is wrong. The gravamen of the FAC is nothing but an attack on Defendants' business judgment – namely, their investment decisions. Because the NCUA seeks judicial interference with the business judgments of Defendants, California's policy of deference to such decisions is directly relevant here – indeed, controlling.

Second, turning to the codified aspects of the Business Judgment Rule, the NCUA errs by claiming that section 7231 rather than section 309 applies. The NCUA notes that California Financial Code section 14002.5, which is part of the California Credit Union Act, incorporates by reference the California Nonprofit Mutual Benefit Corporation Law (which includes Cal. Corp. Code § 7231). Opp. at 8 n.4. But the NCUA overlooks California Financial Code section 14001.1, which expressly provides that the California Credit Union Act (including Financial Code section 14002.5) applies "to any person, *other than a federal credit union engaging in the business of a credit union in this state*." Cal. Fin. Code § 14001.1 (emphasis added). Thus, the very Act on which the NCUA relies expressly excludes WesCorp from its coverage.

Third, even if section 7231 did apply to WesCorp, its operative language is almost identical to section 309 and its effect is no different. The NCUA fails to cite a single authority suggesting that section 7231 differs materially from section 309. And an authority it does miscite, *Frances T. v. Village Green Owners Ass'n*, 42 Cal. 3d 490, 506 n.13, 723 P.2d 573, 582 n.13 (1986), squarely states that "section 7231, the standard of fiduciary responsibility for nonprofit directors, incorporates the standard of care defined in Corporations Code section 309." (citations omitted). This language is one footnote before the footnote that the NCUA cites (Opp. at 12:13-14) yet the NCUA somehow fails to bring

footnote 13 to this Court's attention. Instead, the NCUA makes the facially false argument that *Frances T.* distinguishes between directors of for-profit and non-profit corporations (Opp. at 12:4-13:9), when in fact what *Frances T.* distinguishes between are shareholders (who voluntarily decide to invest in the corporation) and third-party rape victims like the plaintiff Frances T. (who did not volunteer to be raped in the dark condo complex that the defendants had failed to light). *See Frances T.*, 42 Cal. 3d at 507-09, 507 n.14. Try as it might (Opp. at 12:20-13:9), the NCUA cannot credibly argue that credit unions who chose to invest money with WesCorp – investors who voluntarily chose to seek the higher yields that WesCorp offered – are more like rape victims than profit-seeking shareholders. The argument is absurd. Natural-person credit unions could freely choose whether to invest their excess cash with WesCorp or others among the other 27-30 corporate credit unions. FAC ¶ 36. The FAC does not allege that members were unaware of WesCorp's investment strategy or somehow duped into investing their funds with WesCorp. Indeed, the NCUA offers no legal or policy grounds upon which to consider WesCorp's members to be different from shareholders of a for-profit corporation: both weigh risk versus reward, and then decide where to invest their money.

Fourth, the NCUA admits that the "essence of the business judgment" is the "trade-off between risk and return." Opp. at 12:14-19. Yet the NCUA contends that the Business Judgment Rule does not apply to WesCorp because WesCorp was a non-profit. Opp. at 12:20-13:9. This is a *non-sequitur*. Whether or not WesCorp or its unpaid volunteer directors personally made money, it is beyond dispute that they were in the business of making investment decisions on behalf of WesCorp's members. *See, e.g.,* FAC ¶¶ 39, 43. Indeed, the whole point of a credit union is to make money that, while not a "profit" under the Internal Revenue Code, still will benefit its members. *See La Caisse Populaire Ste. Marie (St. Mary's Bank) v. United States*, 425 F. Supp. 512, 522 (D.N.H.

1976), *aff'd*, 563 F.2d 505 (1st Cir. 1977).

More fundamentally, WesCorp was in the business of investing its members' money and thus making decisions about risk and reward. All investments entail "risk," or the chance that a return on an investment will be different than expected. *See In re Citigroup Inc. Shareholder Derivative Litig.*, 964 A.2d 106, 126 (Del. Ch. 2009). Anyone who makes an investment decision for himself or anyone else must weigh risk against reward, knowing that even with the safest investment there is a possibility that returns will be significantly, even catastrophically, lower than expected. *See id.* To deny WesCorp's directors the protection of the Business Judgment Rule simply because they and WesCorp did not profit personally makes no sense. All it would do is deter them from taking any risk, however small – presumably, they would buy nothing but T-bills. Other than hindsight, the NCUA offers no justification for proposing such a rule. Indeed, the NCUA's own regulations permitted – and to this day still permit – all manner of exotic investments, including investments rated far lower than any investment WesCorp's directors ever authorized.[1]

2. The FAC fails to allege facts that rebut the presumptions of the Business Judgment Rule.

To overcome the presumptions of the Business Judgment Rule, the FAC must allege facts showing that the *process* by which Defendants made investment decisions fell below some discernable standard of care. The FAC all

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[1] *See* 12 C.F.R. § 704.5 (Mar. 19, 1997) (permitting credit union investments in corporate debt, repurchase agreements, securities lending, investment companies and forward settlements); *see also id.* § 703.14 (June 3, 2003) (permitting credit union investments in "variable rate investments," REMICs (real estate mortgage investment conduits), "Yankee dollar deposits," "Eurodollar deposits," banker's acceptances, "European financial options contracts" and "mortgage note repurchase transactions"). Amendments set to take effect next year will narrow § 704.5's investment powers subject to some "grandfathering." *See* 75 Fed. Reg. 64786, 64840-41 (Oct. 20, 2010).

but ignores *process*, focusing almost entirely on the *content* of investment decisions. *See* FAC ¶¶ 25-30, 45-53. The FAC's process allegations are few and far between, and most relate to the things that the directors did right: receiving detailed information, setting appropriate concentration limits and living within those limits, buying highly rated investments, monitoring trends, and lowering WesCorp's exposure to riskier investments when risks emerged. *See, e.g.*, FAC ¶¶ 32, 63-66, 74-77; Memorandum in Support of Defendants' Motion to Dismiss Plaintiffs' First Amended Complaint, Doc. 96-1 ("Doc. 96-1"), at 13:14-15:18.

a. The FAC's allegations mainly reflect hindsight disagreement with the content of Defendants' decisions.

The case law and statutes show that judges and juries are ill-equipped to second-guess the content of business decisions in hindsight and therefore should not do so. Yet the main thrust of the FAC is a disagreement about the risk-reward tradeoff in Defendants' business decisions. The FAC does not allege bad faith or violations by these Defendants of the duty of loyalty. Instead, and with nothing but the benefit of 20/20 hindsight, the NCUA claims that these decisions were negligent *because* they led to large losses. *E.g.,* Opp. at 17:8-13. Such allegations cannot overcome the Business Judgment Rule.

The NCUA contends that a fact-finder could determine that Defendants breached their fiduciary duty based on the inferences that could be drawn from the FAC. Opp. at 13:14-14:2. The allegations the NCUA relies upon (without citation to the FAC) are almost entirely content-oriented, however: departing from WesCorp's traditional conservative business model (Opp. at 13:14-15); seeking increases in investment income (Opp. at 13:16-17); continuing to direct WesCorp to seek higher investment income after learning that investment spreads were tightening (Opp. at 13:20-24); setting certain concentration limits (Opp. at 13:24-25, 16:22-24); not imposing concentration limits specifically for Option ARM MBS (Opp. at 13:26-28); and failing to recognize the increased risk

in WesCorp's portfolio (Opp. at 13:16-20). These allegations have nothing to do with *how* Defendants made decisions and everything to do with *what* Defendants decided (or allegedly failed to decide).[2]

Such content-related allegations cannot rebut the Business Judgment Rule. Indeed, they strongly resemble the showing rejected in *FDIC v. Castetter*, 184 F.3d 1040 (9th Cir. 1999). In *Castetter*, the FDIC unsuccessfully tried to overcome the defendants' invocation of the Business Judgment Rule by showing that defendants failed to adopt proper policies concerning loans, capital adequacy, collections and internal controls. *Id.* at 1045. The court held that such proof could not rebut the Business Judgment Rule. The court reasoned that instead of relating to the adequacy of defendants' investigation, such matters "bear on the soundness of the directors' actions based on the information." *Id.* So too here, the FAC's allegations attacking Defendants' policies concerning WesCorp's business model, concentration limits and investments cannot rebut the Business Judgment Rule. *See also Citigroup*, 964 A.2d at 131 (refusing "[t]o impose oversight liability on directors for failure to monitor 'excessive' risk").

With hindsight, the NCUA would rather WesCorp had been more traditional and risk-adverse. But this is precisely the kind of after-the-fact second-guessing that courts should avoid under the Business Judgment Rule.

b. The few process-related allegations in the FAC do not overcome the presumption of the Business Judgment Rule.

The FAC's factual allegations related to process are very limited, and attack Defendants' analysis of that information without adequately alleging a

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[2] The Opposition tries to recast some of the FAC's allegations as process allegations. For example, the NCUA claims that Defendants continued "without further deliberation" to seek higher investment yield. Opp. at 13:21. These assertions – made without citation to the FAC – find no support in the FAC, which alleges nothing about deliberations over seeking higher investment yields.

failure to conduct a reasonable investigation. Such attacks on analysis are little more than invitations to judicial second-guessing of business decisions – invitations that courts should resist particularly when a plaintiff seeks to impose billions of dollars of "personal liability for failure to predict the future and to properly evaluate business risk." *Citigroup*, 964 A.2d at 131.[3]

Even if the FAC's allegations are construed as allegations of insufficient information-gathering as opposed to insufficient analysis, they do not suffice. To overcome the Business Judgment Rule's presumption that directors acted in a reasonable manner, plaintiffs must allege that – *at the time*, not in hindsight – the directors overlooked (1) 'red flags' reasonably calling for further investigation or (2) facts that would have been discovered by a reasonable investigation *and* would have been material to the questioned exercise of business judgment. *Lee*, 50 Cal. App. 4th at 715. The FAC alleges neither (which is particularly ironic given that the NCUA had examiners on-site full-time at WesCorp and real-time access to WesCorp's business records while the investments were being made).

The NCUA acknowledges that Defendants classified and tracked MBS investments by rating (AAA and AA) and FICO score (prime, alt-A and subprime) and used the bond rating of investments to track tranche positions, but now contends – in hindsight – that Defendants *also* should have separately tracked Option ARM MBS and lower tranche MBS in the investment portfolio. Opp. at 14:1-2, 17:4-7; FAC ¶¶ 71-72. The NCUA similarly acknowledges that

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[3] As the Delaware Chancery Court said when faced with allegations that Citigroup overinvested in subprime mortgages: "In any business decision that turns out poorly there will likely be signs that one could point to and argue are evidence that the decision was wrong. Indeed, it is tempting in a case with such staggering losses for one to think that they could have made the 'right' decision if they had been in the directors' position. This temptation, however, is one of the reasons for the presumption against an objective review of business decisions by judges, a presumption that is no less applicable when the losses to the Company are large." *Id.*

the budgets Defendants received "contained detailed information," but now – in hindsight – deems them inadequate because they contained monthly projected totals of investment income, investment expense and net income interest but did not specifically tie changes in projected income to changes in asset allocations. Opp. at 17:14-20; FAC ¶ 65.[4]

These allegations do not establish a failure to investigate; at most they pick nits with the analysis undertaken of the information at hand. The FAC alleges no red flags requiring additional investigation. The FAC also alleges no material facts such investigation would have uncovered, or how those facts would have changed the investment decisions that Defendants made. At most the FAC asks the Court to draw the unsupported inference that more analysis 'coulda, woulda, shoulda' led to different decisions because – in hindsight – the decisions actually made led to large losses. This does not satisfy *Lee*; this does not satisfy *Citigroup*; this is no basis for seeking $6.8 billion from well-intentioned volunteer directors on the theory that they failed to forecast the Great Recession.

The FAC also alleges no discernable duty of care: what the reasonable director would and should have been doing at the time. Instead, the Opposition's discussion of duty is essentially vapor about the "contours of duty." *See* Opp. at 18:18-21. Without some coherent allegation of duty, the NCUA's few procedural allegations cannot overcome the Business Judgment Rule's

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[4] The NCUA challenges Defendants' interpretation of the FAC's admissions regarding ALCO meetings, stating that Defendants' decision to reduce investments in AA-rated MBS was unrelated to ALCO presentations regarding Option ARM MBS. Opp. at 18:1-10. That misses the point. The FAC admits that Defendants attended meetings where they received information about WesCorp's investments and the economy generally. FAC ¶ 74. The FAC does not call into question the adequacy of these meetings. Nowhere does the FAC allege that the meetings were infrequent, that certain directors failed to attend, or that the presentations ignored facts known to be material. The NCUA's ultimate disagreement is with Defendants' investment decisions, not their ALCO meetings.

presumption that Defendants made informed business decisions with due care.

Any business information system and any management report can be improved in hindsight. Given all the time and money in the world, one can always gather more facts and analyze them more thoroughly. But perfection is not the standard. All that the Business Judgment Rule requires is a *reasonable* investigation. *See In re Consumers Power Co. Derivative Litig.*, 132 F.R.D. 455, 483 (E.D. Mich. 1990).

The NCUA contends that it can skate by on inferences and sort out the facts at trial. Opp. at 17:22-27. But the Business Judgment Rule's presumption works the other way, dismissing the marginal complaint, not plumbing it for inferences that might save it from dismissal. "A hallmark of the business judgment rule is that a court will not substitute its judgment for that of the board if the latter's decision can be attributed to any rational business purpose." *Berg & Berg*, 178 Cal. App. 4th at 1045 (quotations omitted). The FAC's attempts to find flaws in Defendants' methods of tracking and budgeting do not come close to raising a plausible inference that Defendants' actions lacked "any rational business purpose."

3. The Court can and should apply the Business Judgment Rule on a motion to dismiss.

It is settled law in California that the application of the Business Judgment Rule is a question of law that is appropriate to decide on a motion to dismiss or demurrer. *Berg & Berg*, 178 Cal. App. 4th at 1045. The burden is on the plaintiff to plead facts that overcome the Rule's presumption of informed, disinterested director actions. *Id.* The NCUA does not even attempt to distinguish *Berg & Berg* on this point. *See* Opp. at 11:24-12:3. The NCUA attempts to distinguish *Barnes v. State Farm Mut. Auto. Ins. Co.*, 16 Cal. App. 4th 365, 20 Cal. Rptr. 2d 87 (1993), *Lee,* 50 Cal. App. 4th at 694, and *Fairchild v. Bank of America*, 192 Cal. App. 2d 252, 13 Cal. Rptr. 491 (1961) on the basis

that those plaintiffs sought declaratory or injunctive relief, and not money damages. Opp. at 12 n.7. This is a distinction without a difference: it is absurd to say that the Business Judgment Rule disappears precisely when it is most needed – when a plaintiff seeks to collect billions of dollars from individuals. Those opinions said nothing suggesting that the Business Judgment Rule applies only to equitable remedies; rather, they applied the Rule because the complaints there suffered from the same defects as the FAC here.[5]

McMichael v. United States Filter Corp., No. EDCV 99-182 VAP (MCx), 2001 U.S. Dist. LEXIS 3918 (C.D. Cal. Feb. 26, 2001), applied Delaware law, but Delaware law is similar to California law on this point, and the court employed well-established principles under Fed. R. Civ. P. 12(b)(6). While the court noted an exculpatory clause in the certificate of incorporation, it nevertheless addressed the merits of the duty of care claim and ruled that the complaint failed to overcome the Business Judgment Rule. *See id.* at *29 n.10, *32-*43. *Findley v. Garrett*, 109 Cal. App. 2d 166, 178, 240 P.2d 421, 429 (1952), also demonstrates that whether or not an exception to the Business Judgment Rule has been adequately pled is a question of law. Thus, the *Findley* court affirmed the sustaining of a demurrer, saying "[t]he board of directors may make incorrect decisions, as well as correct ones, so long as it is faithful to the corporation and uses its best business judgment." 109 Cal. App. 2d at 178.

Citing cases involving personal injury, passing counterfeit bills and

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[5] *See Barnes*, 16 Cal. App. 4th at 379 n.14 (emphasizing trial court's observation that "there must be a showing of facts that would set forth, and not just in a conclusory way . . . a lack of merit in the manner in which [the directors'] work is performed . . . ."); *Lee*, 50 Cal. App. 4th at 716 (dismissing complaint in the absence of "allegations tending to show that [directors'] conclusions were based upon inadequate information . . . ."); *Fairchild*, 192 Cal. App. 2d at 258 (holding that it "appears from the face of the complaint [directors' judgment] has been and will be performed in good faith and in the exercise of its best business judgment.").

landlord-tenant disputes, the NCUA argues that breach of duty is generally a question for the finder of fact. Opp. at 11:2-14. These cases have nothing to do with the duties of directors and officers, and nothing to do with the presumption created by the Business Judgment Rule. Under both California and federal precedents, it is appropriate for courts to decide the application of the Business Judgment Rule on a motion to dismiss. Where, as here, a plaintiff fails to plead facts to overcome the Business Judgment Rule, the complaint must be dismissed for failure to state a claim.

4. The Business Judgment Rule applies to officers such as Burrell.

The NCUA argues that the Business Judgment Rule does not apply to Burrell as a non-director officer. Opp. at 19:24-20:6, citing *Gaillard v. Natomas*, 208 Cal. App. 3d 1250, 1265, 256 Cal. Rptr. 702, 711 (1989). *Gaillard,* however, merely addressed Corporations Code section 309, which speaks only to directors, and did so in the context of a claim implicating the duty of loyalty, and not merely the duty of care. *Id.*[6] *Gaillard* did not address the broader common-law Business Judgment Rule. *See* discussion in Part II.A.1 above. A subsequent California opinion has applied the Business Judgment Rule to an officer/director acting as an officer and not as a participant in a board decision. *Biren v. Equality Emergency Medical Group, Inc.*, 102 Cal. App. 4th 125, 125 Cal. Rptr. 2d 325 (2002). *Gaillard*'s limitation of section 309 is not the last word on applying the Business Judgment Rule to officers in California.

Respected authorities on corporate law agree that the Business Judgment Rule should apply to officers. The American Law Institute's *Principles of Corporate Governance: Analysis and Recommendations* applies the Business Judgment Rule to officers and directors alike. *Principles of Corporate*

[6] *Gaillard* also involved conflicts of interest: acts by officers to secure benefits for themselves. *Id.* at 1265-66. The FAC's First and Second Claims allege no such conflict of interest here.

Governance § 4.01 (Am. Law Inst. 2005); *see also id.* cmt. a ("Sound public policy points in the direction of holding officers to the same duty of care and business judgment standards as directors, as does the little case authority that exists . . . ."). The ABA Committee on Corporate Laws echoes this idea in the commentary to the Model Business Corporation Act, which applies the Business Judgment Rule to officers. *See* 2 Model Bus. Corp. Act Annotated § 8.42, Official Comment at 8-347 (4th ed. 2008) ("[T]he business judgment rule will normally apply to decisions within an officer's discretionary authority."). It is unsurprising that the majority of commentators support the application of the Rule to officers because the "[s]ound public policy" that underlies the Rule applies equally to officers and directors. Like directors, officers should not be deterred from weighing business risk against business reward by the specter of billion-dollar judgments. And the risk of judicial second-guessing and hindsight bias affects judicial review of officers' decisions just as much as it affects judicial review of directors' decisions. Thus, the Rule should protect both.

B. The FAC's Second Claim must be dismissed.

1. The federal gross negligence "floor" does not apply in California.

The directors' moving papers demonstrate that, under *Atherton v. FDIC*, 519 U.S. 213, 117 S. Ct. 666 (1997) and *FDIC v. Castetter*, 184 F.3d 1040, 1043-44 (9th Cir. 1999), the federal gross negligence statutes (12 U.S.C. §§ 1821(k) and 1787(h)) do not apply in California. This is true because California – unlike some states – does not require a showing of more culpability than gross negligence to hold a director or officer liable. Doc. 96-1, at 18:15-22.

Citing *FDIC v. McSweeney*, 976 F.2d 532, 537 (9th Cir. 1992), the NCUA argues that "[t]he first sentence of [12 U.S.C.] § 1821(k) authorizes the FDIC to bring claims alleging gross negligence as a matter of federal law" – whatever California law may provide. Opp. at 20:14-20 (quoting *McSweeney*, 976 F.2d at 537). But *McSweeney* predates by five years *Atherton*'s definitive treatment of

the statute and thus is no longer good law on this point. This Court should look instead to *FDIC v. Castetter*, the Ninth Circuit case that post-dates and relies on *Atherton*. *Atherton* held that 12 U.S.C. § 1821(k) (and by analogy 12 U.S.C. § 1787(h)) "sets a 'gross negligence' floor, which applies as a *substitute* for state standards that are more relaxed." *Atherton*, 519 U.S. at 216 (emphasis added). Citing *Atherton*, *Castetter* held that "[b]ecause the simple negligence standard [of California law] is stricter than the gross negligence standard provided for in 12 U.S.C. § 1821(k) . . . California law is the applicable standard for assessing liability in this instance under *Atherton*." *Castetter*, 184 F.3d at 1043-44.

Unable to muster any post-*Atherton* authority for its position, the NCUA next argues that "[i]f Section 1821(k) or Section 1787(h) simply did not apply when state law imposed a simple negligence standard, there would be no need for the savings clause." Opp. at 21:3-5; *see also* Opp. at 20:21-21:16. This argument ignores *Atherton*'s square holding. *Atherton* first held that there was no federal common law standard for director and officer liability – at least not one that had survived *Erie R.R. Co. v. Tompkins*, 304 U.S. 64, 78, 58 S. Ct. 817, 822 (1938). *Atherton*, 519 U.S. at 217-26. *Atherton* then considered the interplay between the federal gross negligence statute and state laws. At the time when Congress enacted sections 1787(h) and 1821(k), a number of states, faced by the savings and loan crisis of the 1980's, were under political pressure to make the law harder for plaintiffs, and easier for directors and officers, by raising the culpability standard from gross negligence to intentional misconduct or even higher. *Id.* at 228. After reviewing the statutory language and legislative history, the Court held that Congress intended state law to govern if state law requires a plaintiff only to show gross or simple negligence, but section 1821(k) to take effect if state law requires a plaintiff to show more than gross negligence. *Id.* at 227-28, 231. Or, as the Court put it, "[w]e conclude that state law sets the standard of conduct as long as the state standard (such as simple negligence) is

stricter than that of the federal statute. The federal statute nonetheless sets a 'gross negligence' floor, which applies as a substitute for state standards that are more relaxed." *Atherton*, 519 U.S. at 216 ("relaxed" in this sense being from the point of view of the defendant, not the plaintiff). Thus, contrary to the NCUA's revisionist history, the federal statute does not apply, because California law requires only simple negligence – exactly as *Castetter* held. *Castetter*, 184 F.3d at 1043-44.[7]

2. The FAC does not allege facts that rise to the level of gross negligence.

Even if the NCUA could state a claim for gross negligence under 12 U.S.C. § 1787(h), the FAC fails to allege facts sufficient to make the success of such a claim "plausible" under *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 127 S. Ct. 1955 (2007), and *Ashcroft v. Iqbal*, 129 S. Ct. 1937 (2009).

California law defines "gross negligence" as a "want of even scant care" or "an extreme departure from the ordinary standard of conduct." *City of Santa Barbara v. Superior Court*, 41 Cal. 4th 747, 754, 62 Cal. Rptr. 3d 527, 531-32 (2007) (quotations omitted). Because the phrase "gross negligence" is "devoid of all real content," some courts have interpreted it as requiring willful misconduct or recklessness. *Decker v. City of Imperial Beach*, 209 Cal. App. 3d 349, 358, 257 Cal. Rptr. 356, 361 (1989) (quotations omitted). No matter which standard applies, the Second Claim should be dismissed because the FAC fails to allege facts that amount to gross negligence.

The NCUA does not dispute that complaints that fail to allege facts demonstrating an "extreme departure from the ordinary standard of conduct" are properly dismissed on motion. Opp. at 22:20-21. The NCUA's reliance on *Decker* for the proposition that gross negligence is a question of fact (*id.*) is

[7] Because the federal statute does not apply, the point made in the Opposition at 21 n.10 about how California deals with statutory claims of gross negligence has no relevance. There is no statutory claim here.

particularly misplaced, because the *Decker* court found no gross negligence as a matter of law. 209 Cal. App. 3d at 362. As the court recognized, gross negligence is often a question of fact, "but not always." *Id.* at 358 (citing *Devito v. Cal.*, 202 Cal. App. 3d 264, 272, 248 Cal. Rptr. 330, 335 (1988)).

Decker, though factually dissimilar (it involved a bungled attempt to rescue a surfer, *id.* at 352-53), illustrates what is wrong with the FAC's nit-picking approach to Defendants' investment management. The plaintiff in *Decker* argued that the City was grossly negligent "because the rescue personnel elected to try two methods to rescue [the surfer] but failed to try a third method." *Id.* at 361. The Court of Appeal rejected the plaintiff's claim of gross negligence as a matter of law, reasoning: "To avoid a finding of gross negligence, it is not required that a public entity must pursue all possible options. It is required only that they exercise some care, that they pursue a course of conduct which is not an extreme departure from the ordinary standard of conduct." *Id.* (quotation omitted). *See also Devito*, 202 Cal. App. 3d at 272.

Here too it is appropriate to dismiss the gross negligence claim as a matter of law because the FAC admits that the Directors exercised "some care." The FAC admits that Defendants adopted an annual budget that contained detailed information. FAC ¶ 65. The FAC admits that Defendants adopted policies specifying concentration limits for its investment securities and periodically amended the polices to change limits or impose new limits. FAC ¶ 69. The FAC admits that Defendants tracked and reported investments by rating (AAA or AA) and by FICO score (prime, alt-A, and subprime). FAC ¶ 71. The FAC admits that Defendants adopted concentration limits for the investments at issue, and did not exceed them. FAC ¶¶ 69, 73. The FAC admits that Defendants attended ALCO meetings, where they received presentations about the state of the economy generally and WesCorp's investment strategy specifically. FAC ¶ 74. And the FAC admits that Defendants adjusted WesCorp's investment strategy

based on the information presented at the ALCO meetings, first decreasing investments in AA-rated securities and then stopping investments in MBS altogether. FAC ¶¶ 62-64, 75-77. At the very least, these admissions demonstrate that the Directors exercised "some care." Just as the *Decker* plaintiff's nitpicking regarding which particular rescue methods the City should have used did not amount to gross negligence as a matter of law, the NCUA's nitpicking regarding which particular tracking methods should have been used or which specific concentration limits should have been adopted or how much WesCorp should have borrowed (*see* Opp. at 22:15-19) does not, as a matter of law, rise to the level of gross negligence.[8]

In support of its gross negligence claim, the NCUA argues that the FAC "alleges that the acts and omissions of the moving defendants caused the failure of the largest retail corporate credit union in the United States." Opp. at 23:7-9. This statement is representative of the shortcomings of the FAC: it attempts to overwhelm the reader with the specter of big damages while saying nothing factually that might establish the liability of Defendants.

Because the FAC does not allege facts to show that it is "plausible" that Defendants were grossly negligence, the Second Claim must be dismissed.

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[8] The other cases the NCUA cites in its discussion of gross negligence (Opp. at 21:19-22:21) are factually dissimilar from this case. *Fox v. Hale & Norcross Silver Min. Co.*, 108 Cal. 369, 41 P. 308 (1895) is a dated case regarding a conspiracy involving corporate directors. Even if the case was decided under relevant modern standards of director duties, the FAC does not allege that Defendants completely abdicated responsibility to others, as was the case in *Fox*. *Id.* at 387. *Van Meter v. Bent Construction Co.*, 46 Cal. 2d 588, 590, 297 P.2d 644, 645 (1956), involved a contract between a contractor and subcontractor, and *City of Santa Barbara*, 41 Cal. 4th at 747, involved a contractual release for gross negligence in the context of a wrongful death suit. Neither case is at all on point.

C. The statute of limitations bars the First and Second Claims as to Cheney, Rhamy and Updike.

1. The First Claim does not plead wrongdoing in the limitations period.

As noted in our moving papers (Doc. 96-1, at 22:12-27) and in the Opposition (Opp. at 23:16-26), the Court is constrained to apply the four-year catch-all statute of limitations. Thus, the question presented is whether the First Claim accrued within four years before the date of the conservatorship, March 19, 2009. *See* FAC ¶ 1.

The NCUA argues that "[t]he claims against the officers and directors accrued at the time the questionable securities were purchased." Opp. at 23:27-24:2 (citing *FDIC v. Jackson*, 133 F.3d 694, 696-697 (9th Cir. 1998) (construing Arizona law)). For purposes of this motion, we are willing to assume that *arguendo*, despite the obvious irrelevance of Arizona law to this case.

The NCUA next argues that its "claims are based on purchases of private label MBS in 2006 and 2007" and thus are timely. Opp. at 24:2-3. This argument is backed by no citation to the FAC and finds no support in the FAC. Nowhere does the FAC allege any purchases of "questionable securities" in 2006 or 2007 – or 2005, for that matter. [9] Indeed, *nowhere does the FAC ever actually specify the names and dates of purchase of any "questionable securities," or who approved the purchase*. All the FAC does is list the dollar amount of WesCorp's total assets annually since 2002 and suggest that the concentration of AA-rated securities declined after 2005. *See, e.g.*, FAC ¶¶ 45-47, 63.

In the hands of a private plaintiff without access to pre-filing discovery, such vague and conclusory allusions would not state a claim against these three

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[9] Cheney left the board in February 2006, and Updike and Rhamy in April 2006. FAC ¶¶ 17, 20, 21. Thus, purchases of "questionable securities" would have to be before their departure dates and after March 19, 2005 to have any conceivable relevance to them. No such purchases are alleged.

defendants. *A fortiori*, in the hands of a government agency that had total control of WesCorp's documents and personnel for 18 months before filing the FAC (and had on-site real-time access to WesCorp's business records back when investments were being made), such vagueness cannot possibly be excused.

2. The Second Claim is time-barred and cannot be resurrected.

Citing clear Ninth Circuit authority, our moving papers demonstrated that the NCUA could not revive claims that were time-barred as of the date of the conservatorship. Doc. 96-1, at 21:16-22:4 (citing *McSweeney*, 976 F.2d at 534). *McSweeney* interpreted 12 U.S.C. § 1821(d)(14), the FDIC analogue to NCUA's 12 U.S.C. § 1787(b)(14), holding that section 1821(d)(14) – while giving the regulator three years *after* imposition of a conservatorship to bring tort claims against former officers and directors – does not revive claims for which the state-law statute of limitations has expired *before* the date of receivership. *McSweeney*, 976 F.2d at 534.

Noting that the FDIC in *McSweeney* asserted only a state-law claim (breach of fiduciary duty), the NCUA argues that the "no-resurrection" rule applies only to state-law claims that the NCUA acquired from WesCorp, not to federal claims created by the NCUA as conservator. Opp. at 24:5-27. The NCUA cites no authority so holding, and the argument is wrong:

First, *McSweeney* does not hold, or even suggest, that federal claims are exempt from the no-resurrection rule. Nor do other circuits that have construed section 1821(d)(14). *See RTC v. Armbruster*, 52 F.3d 748, 750 (8th Cir. 1995); *RTC v. Artley*, 28 F.3d 1099, 1101-02 (11th Cir. 1994); *FDIC v. Dawson*, 4 F.3d 1303, 1306-07 (5th Cir. 1993); *FDIC v. Regier Carr & Monroe*, 996 F.2d 222, 225 (10th Cir. 1993); *RTC v. Bright*, 872 F. Supp. 1551, 1570 (N.D. Tex. 1995). Indeed, courts that have considered whether a conservator or receiver of a failed financial institution can assert gross negligence claims against the institution's former directors and officers have held that state statutes of limitations govern

such gross negligence claims, which cannot be revived once the state statute has run. *Artley*, 28 F.3d at 1101-03; *Bright*, 872 F. Supp. at 1570.[10] These cases completely undermine the NCUA's theory.[11]

Second, the NCUA's argument is even weaker than it would be in the hands of the FDIC/RTC, which (as shown) has had no luck arguing against the no-resurrection rule. The FDIC/RTC, at least, had a statutory basis for resurrecting certain expired claims, albeit one limited to state-law claims for "fraud" or "intentional misconduct," that expired not more than five years before the imposition of the conservatorship. *See* 12 U.S.C. § 1821(d)(14)(C) ("Revival of expired State causes of action."). But the NCUA's comparable statute, 12 U.S.C. § 1787(b)(14), contains no revival statute like subsection (C). The NCUA has contemplated asking Congress for such a revival statute, but has not done so, much less succeeded in obtaining such a statute from Congress.

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[10] The NCUA overlooks *Artley* and *Bright*, and relies instead on a trio of irrelevant cases. *King v. United States*, 301 F.3d 1270, 1277 (10th Cir. 2002), cited by the NCUA for the proposition that a federal statute of limitations must govern a gross-negligence claim under 12 U.S.C. § 1787(h) (Opp. at 24:5-15), has nothing to do with section 1787, or section 1821, or statutes of limitation. *Bunnell v. Dep't of Corrections*, 64 Cal. App. 4th 1360, 1369, 76 Cal. Rptr. 2d 58 (1998) holds merely that where a federal statute of limitations expressly governs a federal claim, that statute governs and state statutes of limitations do not. *LLP Mortg. v. Bizar*, 126 Cal. App. 4th 773, 777-78, 24 Cal. Rptr. 3d 598, 602 (2005) holds merely that a federal statute of limitations governs federal Small Business Administration loans (citing both federal and California opinions so holding with respect to SBA loans).

[11] Only two pre-*Atherton* cases suggest otherwise, and neither is persuasive here. In *RTC v. O'Bear, Overholser, Smith & Huffer*, 840 F. Supp. 1270, 1280-81 (N.D. Ind. 1993), the court held that section 1821(k) created an independent federal cause of action that was unaffected by state statutes of limitation. As discussed above in Part II.B.1, *Atherton* and *Castetter* made clear that section 1821(k) does not create such an independent cause of action in California. *O'Bear*'s holding – if it survived *Atherton* at all – is therefore irrelevant here. *RTC v. Zimmerman*, 853 F. Supp. 1016, 1021 (N.D. Ohio 1994) relied on *O'Bear* without further discussion (defendants had conceded the point), and can be disregarded for the same reasons.

Third, lacking any basis in relevant statutes or case law to resurrect expired claims, the NCUA cites a pair of cases that predate sections 1821(k) and 1787(h) and therefore say nothing about these statutes, or about sections 1821(d)(14) and 1787(b)(14), or indeed about any federal claim. Opp. at 24:16-27 (citing *FDIC v. Former Officers & Directors of Metro. Bank*, 884 F.2d 1304 (9th Cir. 1989) and *Guaranty Trust Co. v. United States*, 304 U.S. 126, 142, 58 S. Ct. 785 (1938)).

Fourth, adopting the NCUA's interpretation would permit the NCUA to revive claims stretching back decades simply by imposing a conservatorship and suing within three years. Other courts have refused to implement such an interpretation for claims under section 1821(k) for precisely that reason, holding that Congress could not possibly have intended to give FDIC/RTC (and, by analogy, the NCUA) such sweeping revival powers. *See Artley*, 28 F.3d at 1102-03; *Bright*, 872 F. Supp. at 1570. As the *Artley* court put it, "this approach would permit the RTC to resurrect claims stale from the early twentieth century. The evidence that Congress intended such a sweeping recovery right is not persuasive." *Artley*, 29 F.3d at 1102 n.6 (quotation omitted).

Thus, the NCUA has no legal basis to revive expired claims, be they state or federal. And its Opposition does not even attempt to show that the FAC alleges misconduct by Cheney, Rhamy or Updike within two or three years (*see* Doc. 96-1, at 22:28-24:11) of the imposition of the conservatorship. *See* Opp. at 24:4-27. Accordingly, the Second Claim must be dismissed as to Cheney, Rhamy and Updike.

D. Dismissal should be without leave to amend.

Our moving papers explained why the NCUA, after 18 months of investigation and total control of the evidence, should not be granted leave to amend. *See* Doc. 96-1, at 24:12-25. The NCUA does not even attempt to address this point or our authorities.

III. CONCLUSION.

For each of the foregoing reasons, the FAC should be dismissed without leave to amend.

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